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To the General Manager

Submission to Consultation on Revisions to Prudential Practice Guide APG 223 Residential Mortgage Lending

The Urban Development Institute of Australia (UDIA) National welcomes the opportunity to provide feedback on the proposed revisions to Prudential Practice Guide APG 223 Residential Mortgage Lending – which relates to loan serviceability requirements for authorised deposit taking institutions (ADIs).

About UDIA National

UDIA is the development industry's most broadly representative industry association with more than 2,500 member companies – spanning top tier global enterprises and consultants to local governments and small-scale developers.

We have a long history of engaging positively with the Federal Government and its agencies on issues critical to the property industry – spanning tax, population, infrastructure, land use planning and beyond.

UDIA National's advocacy is defined by our state-representative National Council – and informed by a diverse membership base, extensive network of state councils and committees and businesses on the frontline of housing development around the country.

Our voice is backed by real experience and quality research designed to support good policy making and dialogue with governments, oppositions and the bureaucracy.

Introduction

UDIA is broadly supportive of the proposed revisions to Prudential Practice Guide APG 223 Residential Mortgage Lending.

We recognise the primary mandate of the Australian Prudential Regulatory Authority (APRA) is to establish and enforce prudential standards and practices that underpin a sound and stable financial system. UDIA National supports sensible lending practices as the stability of the financial system is an essential plank of a strong economy.

However, just as these tools can be designed and deployed to curb lending practices perceived as excessively risky, so too should they be conceived in a way that maintains a reliable and dependable flow of credit in the economy, which is needed to sustain normal economic functions such as home lending.

When APRA announced new loan serviceability assessments in December 2014, the state of lending practices and housing markets were substantially different from their current status. This shift in conditions makes the proposed amendments to APG 223 timely and essential.

Weakening housing markets

In the period since December 2014, there have been substantial changes in the conditions and composition of housing markets and lending practices. These include:

- **A continued decline in housing prices** – with declines particularly focused on Sydney, Melbourne and Perth and prices down approximately 10 percent in the past year[1]

- **Housing market conditions generally remaining soft** – with vendor discounts and days on the market elevated, turnover declining, auction levels and clearance rates remaining low[2]

- **Dwelling investment passing the peak** – with the decline in new construction continuing, and a particularly sharp fall observed in the December 2018 and March 2019 quarters[3]

- **New housing construction forecast to contract** – with building levels trending lower for the past year and implying a much lower level of activity once the current pipeline is completed[4]

In fact, housing approvals have now reached a near five-year low. Dwelling approvals data released by the Australian Bureau of Statistics in March 2019 shows that:

- Seasonally adjusted **approvals fell** from 17,083 in February to 14,429 in March

- The **rolling annual total of approvals fell to 199,428** in March – the first time since May 2014 that the number had sat below the 200,000-approval mark

- Although the decline was concentrated in the apartment market, there were also continued falls in the detached housing market.

These weaknesses will continue to manifest themselves through the economy – in higher rents, an imbalance between supply and demand that risks refuelling house price rises, and broader economic risks given the importance of new housing construction to jobs and economic growth.

[1] RBA Statement on Monetary Policy – May 2019
[2] RBA Statement on Monetary Policy – May 2019
[3] ABS Data
[4] RBA Statement on Monetary Policy – May 2019

Improved lending standards

APRA's proposed amendments to APG 223 recognises that, in combination with a series of other prudential measures and standards implemented in the past five years, lending standards have improved, and adjustments are now timely.

APRA acknowledged this in its Information Paper (*Review of APRA's prudential measures for residential mortgage lending risks*) released in January 2019. It explored strategic and tactical decisions taken by APRA to strengthen resilience of individual ADIs and the financial system overall.

The paper observed:

"There has been a notable shift in housing market dynamics more recently, which by some accounts has been in part been driven by some lenders adopting a highly cautious approach to lending."

It explored the range of measures APRA had progressively initiated to improve lending standards, which included the imposition of the new loan servicing benchmarks in December 2014. These also included two significant measures – a 10 percent benchmark on the annual growth of housing lending to investors in December 2014, and the introduction of a 30 percent benchmark on the flow of new interest-only lending as a share of total new residential mortgage lending in March 2017.

APRA has since announced the removal of the two relevant benchmarks (subject to conditions) given they have had the intended policy effect. Interest only lending among all ADIs now sits below 30 percent and has more than halved among the major banks. Similarly, the growth in lending to investors has dropped sharply (and has inverted against the rate of growth for owner-occupiers).

Overall, the measures have had the collective impact of achieving APRA's original goal. As the paper notes:

"These actions have led to a marked strengthening in residential mortgage lending standards and improvement in the risk profile of mortgage lending in Australia."

As a consequence, the prior removal of the two benchmarks related to investor lending and interest-only loans were justified; and the current proposal to amend APG 223 is also now timely, given it is also matched with softer housing conditions.

Recommended Reforms

UDIA National wishes to comment on the two proposed substantial reforms proposed by APRA, namely:

- Removing the quantitative guidance on the level of the serviceability floor rate – that is, the specific 7 percent floor rate
- Increasing the serviceability buffer from at least 2 percent to 2.5 percent.

Removal of the floor rate

UDIA National fully supports removal of the guidance related to a 7 percent serviceability floor rate. As APRA itself notes, the 7 percent rate is less relevant given the current interest rate environment – with the RBA having cut the cash rate to 1.25 percent in June. It also acknowledges banks are well placed to set their own floor rate within the overall context of their portfolio mix, differential pricing, risk appetite and other relevant factors.

UDIA endorses this proposal and urges APRA to proceed with the proposed amendment to Section 33 of APG 223.

A 2.5 percent serviceability buffer

UDIA National does not see merit in switching the requirement for an ADI's serviceability policies to incorporate an interest rate buffer of at least two and a half percent – an increase from the current guidance of a buffer of two percent.

While we understand the need for lenders and borrowers to be aware of the potential shift in interest rates and consequences of higher mortgage servicing costs, there are two main arguments against an increase in the guidance from two to two and a half percent.

As APRA itself notes, the bulk of ADIs currently use a 2.25 percent buffer in their assessments and APRA has not laid out a specific case for recommending a 2.5 percent buffer (beyond asserting it will help maintain produce in overall serviceability assessments)

Also, while the concept of buffers is sound, but needs to be anchored in the logical risks attached to potential future movements in interest rates. Using the RBA cash rate as a proxy for interest rates, there have been only two increases in rates above the two percent buffer in the past 25 years.

One of those occurred as far back as 1994. The only other increase in the cash rate since above the two percent buffer occurred over almost a six-year period – from April 2002 to February 2008 – and saw the cash rate increase by 2.75 percent over a span of 70 months.

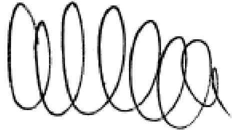
As a consequence, and absent a more detailed explanation from APRA on the specific case for a buffer of 2.5 percent, we would recommend against amending APG 223 to incorporate a change from 2 percent.

Conclusion

UDIA National welcomes the opportunity to engage with APRA on these issues and commends APRA on its approach to continuing to seek a balance between managing prudential risks and maintaining healthy lending conditions. We would be happy to discuss any element of our submission further.

I can always be reached on 0412 244 988 or via email to ckirk@udia.com.au.

Yours sincerely,



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